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On measures to change the VAT system to fight fraud

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COMMISSION STAFF WORKING PAPER

More far-reaching measures to tackle VAT fraud

1. BACKGROUND

The Commission's Communication on fiscal fraud of 31 May 2006[1] raised the idea of changes in the current Value Added Tax (VAT) system as a possible option to tackle currently experienced VAT fraud, either via a generalised reverse-charge system, where liability for VAT payments would be shifted from the supplier to the purchaser, or by taxing intra-Community supplies of goods[2]. The ECOFIN Councils of 7 June 2006 and 28 November 2006 welcomed the Communication and started examining these two options.

The ECOFIN Council of 5 June 2007 expressed the view that the preferred system of taxing intra-Community supplies should be based on taxation in the Member State of departure and not in the Member State of arrival, and invited the Commission to continue examination of this system as regards the required clearing procedure between Member States. The Council noted also that a majority of Member States expressed reservations about an optional generalised reverse-charge mechanism but called on the Commission to analyse the potential effects of such a system and to examine the possibility of a pilot project in a Member State.

The purpose of this working document is to provide an analysis of the taxation of intra-Community supplies and the optional reverse-charge system.

2. TAXATION OF INTRA-COMMUNITY SUPPLIES OF GOODS IN THE MEMBER STATE OF DEPARTURE

2.1. Methodology

Following the Council request, the basic elements of such a system were examined and developed on the basis of Member States' replies to a questionnaire from the Commission and by the Commission's own analysis. In this context, the (bilateral) clearing mechanism was considered to be the most essential element. The results should allow a political decision to be taken on the usefulness of carrying out further in-depth and detailed analysis and design of the other, more detailed, aspects of the system (e.g. choices to be made as regards simplification for triangular supplies, transfer of goods, special schemes, etc.).

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1 COM(2006) 254.

2 For the Communication on conventional fraud measures, reference is made to COM(2007) 758.

2.2. Basic concepts of the system

2.2.1. General

The system of taxation of intra-Community supplies in the Member State of departure is based on the following assumptions for the purposes of this working document:

- The current system would generally remain applicable except where specified differently below.

- A taxable person making an intra-Community supply[3] must charge, at a common rate of 15%, VAT to his customer who is a taxable person or a non-taxable person acting as such in another Member State.

- As a general rule, no VAT would be due after transport or dispatch of the goods to the Member State of arrival; equivalent to an intra-Community acquisition.

- However, in order to guarantee the neutrality of the system the purchaser would declare, in cases where he is not entitled to deduct the VAT in full, an intra-Community acquisition in the Member State of arrival and account for the VAT difference that might occur, either positive or negative, between the rate of 15% charged on the operation and the domestic rate applicable in that Member State.

- The purchaser would be entitled to deduct the VAT he has paid to his supplier and the VAT he has accounted for because of the rate difference via the VAT return and according to the right-of-deduction rules of the Member State of arrival. The purchaser would, under all circumstances, need to have an invoice from the supplier before being allowed to exercise his right of deduction[4].

- Since VAT would be paid in the Member State of supply and deducted in another Member State, linking supply and acquisition listings would become even more important in order to respond to the inherent risk of deduction without a corresponding payment. As a further step, and in order to minimise the number of mismatches between these listings, it could be an option to change the rules governing the time the tax becomes chargeable[5], and to link it entirely to the issuing of the invoice insofar as the VAT becomes due in any case if an invoice has not been issued within a certain period.

- VAT receipts in respect of the intra-Community supply and the subsequent acquisition should accrue to the Member State where the intra-Community acquisition has taken place. Even when the recipient is not entitled to deduct the VAT in full, the amount remitted from the Member State of supply to the Member State of arrival would always be the 15% VAT charged on the intra-Community

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[3] For the purposes of this Communication, 'intra-Community supply' is a supply which is currently exempt under Article 138(1) of VAT Directive 2006/112/EC.

[4] See also Article 178(c) of VAT Directive 2006/112/EC.

[5] See Articles 67 and 69 of VAT Directive 2006/112/EC on the chargeability of the VAT in relation to, respectively, intra-Community supplies and intra-Community acquisitions.

supply. Any VAT gain from a taxable person not having a full right of deduction would accrue to the Member State of arrival.

- These principles require a clearing mechanism between Member States in order to ensure that the VAT receipts accrue to the Member State where the intra-Community acquisition has taken place.

2.2.2. *Clearing procedure*

A taxable person making an intra-Community supply will charge 15% VAT on the consideration to a taxable person in another Member State. The taxable person in the Member State of supply will declare the VAT on his domestic VAT return and pay the amount due to his tax authority. This VAT needs to be remitted to the Member State of intra-Community acquisition from the Member State of supply.

Since intra-Community supplies would be taxed, every Member State of supply will have to remit VAT to the Member States of intra-Community acquisition. At the same time, the Member State of supply will also receive VAT from other Member States in relation to intra-Community acquisitions made in its territory.

It is envisaged that the clearing system would be bilateral between Member States based on microeconomic data collected at an individual level from taxable persons in the Member State of departure and the Member State of arrival of the goods. In this context there are three possibilities for collection of this data:

- By means of the normal VAT declaration.

- By means of a monthly recapitulative statement with global amounts per customer/supplier.

- By means of a monthly recapitulative statement at invoice level by suppliers and purchasers.

It seems sensible to build upon the existing information obligations. For this reason, the second and third options are preferred over the first option.

In the Commission's view, the second option appears on balance more advantageous than the third option. Option two builds on the current concept regarding the taxable person making intra-Community supplies. Given the Commission's intention to make a proposal for monthly recapitulative statements, following Member States' general support in the Anti Tax Fraud Strategy (ATFS) working group, the reporting obligations for suppliers may not need any further change.

Option two would require, of course, that a taxable person making acquisitions would also be obliged to submit monthly recapitulative statements. The cost of these changes is detailed in section 2.6.1.

Whilst the third option would provide most detailed information for Member States, it is difficult to imagine how they would deal with the volume of data they would receive (and follow up mismatches, including those stemming from currency exchange calculations). Moreover, it would be likely to impose disproportionate burdens on taxable persons doing business in the Single Market as making intra-Community supplies/acquisitions would become significantly more burdensome than making domestic supplies/purchases.

A study by the consultant looked at the cost to businesses of a requirement to record information on the recapitulative statement at invoice level instead of on a company-to-company basis. An average one-off fixed cost of €62 000 and an average annual recurring cost of €2 250 was calculated. Unfortunately, this can not be extrapolated (due to the small sample involved) to determine an estimated total EU cost.

2.3. The effects of taxing intra-Community supplies

In the first place such an approach ensures a higher level of equal treatment between intra-Community and domestic supplies. However, there will be no full parallelism as the rates applicable will differ, although to a much a lower extent than today.

Moreover, the current risks for the supplier of an intra-Community supply to exempt such supply, where the conditions for the exemption are not fulfilled, would diminish, as his risk regarding an (unforeseen) VAT payment, arising from the supply made, would be limited to the potential difference between the common rate of 15% and the rate applicable to his domestic supplies.

2.4. Risks of new fraud, and efficiency in eliminating existing fraudulent activities

A study carried out by an external consultant forms the basis for evaluating fraud risks from introduction of taxation of intra-Community supplies.

(1) New risks of fraud

The study presents two main forms of fraud likely to result from taxation of intra-Community supplies. Firstly, the Member State of acquisition allows the taxable person a right of deduction without the supplier paying over the VAT to the Member State of supply. Secondly, a taxable person creates an artificial refund position using a taxed intra-Community supply, more likely in combination with a third-country export. These frauds could involve false intra-Community invoices.

These types of fraud are facilitated by the fact that payment of the VAT is made in one Member State and the deduction is allowed in another Member State. As the study points out “this might enhance the risk of deduction without an underlying payment”. If combined with a deferred payment scheme for imports, where the VAT is charged and deducted at the same time on the VAT return, the likelihood of VAT not remitted on a subsequent taxed intra-Community supply is increased.

In addition, the study states that rate differentials might be **exploited** for fraudulent purposes. For instance, a domestic zero-rated supply is changed to a taxed intra-Community supply at 15% which, when followed by a domestic zero-rated supply of the same goods, would create a false right to a VAT refund. Also, taxable persons without a full right of deduction may exploit rate differentials between the domestic VAT rate and that of taxed intra-Community supplies.

To counter these possible frauds, the report suggests that a reporting system for intra-Community supplies and purchases is put in place. This should be accompanied by improved control measures on the part of the tax authorities, better cooperation between Member States in exchanging information and improved controls in respect of third-country exports.

(2) Elimination of existing fraudulent activities

The elimination of all existing fraudulent activities is not the aim of taxing intra-Community supplies. Taxing intra-Community supplies will not tackle VAT loss through the black economy, contrived insolvencies or other domestic VAT frauds that currently exist.

Rather, the measure aims to target the specific fraud known as missing trader intra-Community (MTIC) fraud. It aims to do this by ending the current exemption for intra-Community supplies which allows continual VAT repayments for the circular flow of goods in and out of a Member State for which VAT is uncollected at a previous stage.

The study does not address whether taxing intra-Community supplies effectively eliminates the existing MTIC fraud, but whether new forms of fraud would arise. In this respect, though, the study does identify a mutation of MTIC fraud from intra-Community supplies to third-country exports.

Under the present MTIC fraud, a taxable person effecting intra-Community acquisitions goes missing without paying over the VAT he received from his customer on his onward domestic supplies. This is followed by an exempt intra-Community supply by that customer providing him with a repayment of the VAT paid to his supplier. Under the mutated fraud, a VAT refund because of exempt intra-Community supplies would be replaced by a VAT refund as a result of third-country exports. The overall effect is, however, the same with a request for a refund of uncollected VAT at a previous stage.

However, the study states that this type of third-country MTIC fraud is likely to occur but only for a limited period of time, in fact on a one-off basis. The difficulty for fraudsters is the declaration requirements for third-country imports and exports and the enhanced customs controls. The advantages afforded to businesses with the free movement of goods in the EU, and simplified reporting obligations, is absent in respect of third countries.

Furthermore, the study states that MTIC fraud could remain by exploiting rate differentials. Whilst the fraud gain would be less, it could nevertheless remain significant. Those Member States with a high domestic rate, for instance Denmark and Sweden with a standard rate of 25%, could remain susceptible. In effect, the taxable person making an intra-Community supply at a 15% VAT rate, yet purchasing the goods at a domestic VAT rate of 25%, would be entitled to a VAT refund of 10% of the value of the goods. The domestic supplier, having purchased the goods via an intra-Community supply, would not remit the equivalent VAT to the tax authorities.

2.4.1. Conclusion

The Commission believes that the taxation of intra-Community supplies would significantly reduce the attractiveness of MTIC fraud in that fraudsters could only profit from a differential between 15% and the standard VAT rate. This would probably mean that fraudsters would have to concentrate their efforts on those Member States with high standard rates and would be easier to identify.

The taxation of intra-Community supplies would however not solve existing domestic VAT fraud and may even add to the magnitude of such fraud.

2.5. Competitive aspects

A founding principle of the VAT Directive is to promote effective removal of the restrictions on the movement of goods between Member States. The common VAT regime should be neutral as regards the origin of goods and their stage of production or distribution, so that a common market, permitting fair competition and resembling a real internal market, may be achieved. This is of particular importance when the level of intra-Community trade is considered. With over two and a half million businesses across the EU making intra-Community purchases of over €2 400 billion[6], it is important that this level of trade is not significantly disrupted or hampered by any new regime. The relative simplicity of the current scheme should not be discounted when comparing it to an alternative. In principle, a business which has a full right to deduct would be unaffected by the taxation of intra-Community trade, and would apply the same principle to intra-Community acquisitions as it does to domestic purchases, and pay the VAT due to its supplier and reclaim this as input tax on its VAT return.

2.5.1. Cash flow

The main competitive aspects could therefore be assumed to only arise from possible cash-flow effects, which are exceedingly difficult to evaluate. In principle, the introduction of taxation would suggest that the overall amount of the value of intra-Community exchange would in future have to be pre-financed at the common rate of 15%. This would amount to some €360 billion of tax to be financed.

Such a figure has, however, to be looked at in the context of a number of variables that can influence the overall cash-flow situation.

These variables for businesses currently making intra-Community supplies and acquisitions and who would continue to do so were the system to be changed are:

- The credit terms allowed by creditors.
- The credit terms granted to debtors.
- The length of time taken by Member States to make VAT refunds.

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[6] Eurostat 2006 figure.

- The length of time between the taxable event and the date on which the VAT becomes payable.

(1) Cash-flow issues arising from the relationships between businesses

A taxable person making intra-Community supplies who does not grant credit terms to his customers will enjoy a cash-flow gain because his customer will pay him the VAT on the supplies immediately and that VAT does not have to be paid to the Treasury until the date the VAT becomes payable.

On the other hand, a taxable person who allows credit terms will suffer a cash-flow loss if the length of the credit terms exceeds the difference between the time he allows his customer to pay him and the time his own Member State allows for the payment of the VAT.

A taxable person making intra-Community acquisitions without credit terms from his suppliers will suffer a cash-flow loss because he will have to pre-finance the VAT on the goods which up to now had not been subject to VAT.

A taxable person making intra-Community acquisitions with credit terms from his suppliers will have a cash-flow gain if the period allowed by his suppliers is greater than the period within which he is obliged to submit his VAT declaration.

(2) Cash-flow issues arising from the relationship between taxable persons and the administration

A taxable person not granting credit terms and currently in a refund situation because he makes intra-Community supplies will have a cash-flow gain because he will receive the output VAT from his customers earlier than he would have received the refund on their inputs from his Member State. He would change from being a taxable person entitled to refunds to being a taxable person with liabilities to the Treasury.

Such taxable persons who grant credit terms (but who do not receive credit terms from their suppliers) will suffer a cash-flow loss if the credit terms given exceed the length of time it takes for the Member State to make a VAT refund. This situation would also apply to taxable persons exporting goods where some of the goods have been acquired from taxable persons in other Member States, as the exporter would have a higher VAT deduction due to an increase in taxed acquisitions.

Those Member States that make VAT refunds quickly would incur a cash-flow loss, at least in the first year of operation, as they would be allowing input credit to their taxable persons before they had received compensation *via* the clearing system from the Member State of the supplier. In those Member States in which VAT refunds currently take longer, businesses would experience a cash-flow advantage if the length of time taken to make refunds currently exceeds the credit terms allowed by suppliers.

In conclusion, if there were no credit terms, or if credit terms were 15 days maximum, it is likely that sellers in intra-Community trade would profit from an overall cash-flow advantage whereas purchasers would suffer additional financial burdens. However, what is clear is that there will be an overall cash-flow loss which would have to be financed. As it is more likely that stronger players in a market would maintain their profit margin, it would appear that any additional financing cost would find its way down to the consumer in terms of increased prices which would have the effect of increasing inflation, at least in the first year of operation.

2.5.2. Rate differentials from that of the common rate of 15%

Competitive aspects may arise in Member States which have a number of reduced or zero rates. A business in a Member State which applies a reduced rate to a particular commodity may be reluctant to purchase from another Member State, with the need of having to pre-finance VAT at 15% rather than at the lower amount if purchased domestically.

Similarly, in Member States that apply a rate higher than 15% to most goods, the rate of 15% may create an attraction to buy from another Member State rather than domestically.

Both arguments appear to be correct in theory but to be rather irrelevant in practice. In fact, by that same logic the current system would — by exempting intra-Community supplies from tax – lead to an incentive to buy in another Member State rather than domestically, and this scheme may well have contributed to economic integration even if transport has certainly offset some of the potential advantage. Basically, however, trade in goods is determined by specific needs and market requirements. The experiences gathered so far suggest that such rate differentials have no major competitive effects.

2.5.3. Conclusion

The rate differentials will be reduced by comparison to the current situation for which no complaints have been formulated as to their competitive aspects. The Commission, therefore, does not consider this to be an important distorting element.

The Commission is more concerned about potential cash-flow effects in so far as such effects could increase overall costs of intra-Community supplies. Such costs could be particularly harmful to small businesses' opportunities to benefit from the Single Market. On the other hand, the Commission does not think that these effects need to be overstated as current pre-financing with substantial refund delays also causes substantial costs for such transactions, and to which small businesses are more exposed than larger businesses.

2.6. Estimate of additional costs for taxpayers and tax administrations

The Commission did not have sufficient information at its disposal to be able to provide a rough estimate of the additional costs, either for taxpayers or the tax administrations, of a system of taxing intra-Community supplies. For this reason, a questionnaire was sent to Member States on 2 August 2007.

That questionnaire focused on the costs of implementing taxation of intra-Community supplies. This was split between information requested on taxpayers and information on tax administrations.

In addition, a study was commissioned to identify extra costs for monthly and more-detailed recapitulative statements. These results are used here in relation to the additional costs on taxpayers.

2.6.1. *Additional costs for taxpayers*

Three areas were identified that could impact on the costs for taxpayers in moving to a system of taxing intra-Community supplies. These were reporting obligations, possible removal of the simplification rules (Article 141 of the VAT Directive in relation to triangular supplies) and cash-flow effects. We will refer below only to the reporting obligations.

A clearing system based on information at the microeconomic level, that is to say the level of businesses, would impose extra obligations for businesses both supplying goods to and purchasing goods from another Member State. In the view of the Commission, both would need to provide a **monthly recapitulative statement covering supplies and acquisitions**. Neither this mirror reporting nor its frequency is (yet) required under the current system, although a proposal aimed at the introduction of such changes is likely to be presented to the Council shortly.

(a) Taxpayers making taxed intra-Community supplies

From the information received from the Member States replying to the questionnaire, it transpires that 4.3% of the 28 million taxable persons who submit VAT returns in the EU complete recapitulative statements today — that is 1.2 million taxable persons. Of these, less than 10% (114 796) submit recapitulative statements on a monthly basis. Thus, a new obligation for a monthly recapitulative statement would at most concern the remaining one million or so taxable persons (see table in Annex).

The study provides some indication of the extra cost for businesses in this respect. Based on the standard cost model and using a sample of 10 large and SME businesses in Belgium, Denmark and Hungary, an average fixed cost of approximately €350 and an average recurring cost of €6 300[7] per annum would be the extra cost of imposing monthly recapitulative statements. Due to the small sample used, these cost figures cannot be extrapolated to determine an estimated total EU cost. Disregarding the inexplicably very high figure for the one large company, the overall average recurring cost would amount to some €1 300 per annum. Moreover, the rigidity of the electronic procedure put in place in certain Member States has had a considerable impact on the recurring cost, and the implementation of a more flexible procedure for the transmission of data would reduce this cost.

(b) Taxpayers receiving taxed intra-Community supplies

About 9% (2.6m) of taxpayers make intra-Community acquisitions. Under the envisaged system of taxing intra-Community supplies they would be required to submit a monthly intra-Community acquisition listing at invoice level.

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7 This average is affected by the small size of the sample and the fact that one large business estimated recurring costs at €56 000. For most of the other businesses (large and SME) the cost was estimated to be less than €4 000. The average cost for large businesses was €11 224 — again influenced by the very high figure of the one large business.

The additional cost for taxpayers of complying with this obligation could be assumed to be equivalent to the costs resulting from monthly recapitulative statements; since this will be a new information obligation rather than an adaptation of an existing obligation, the one-off fixed costs could be significantly higher — at least for those traders who are not at the same time making intra-Community supplies and acquisitions.

2.6.2. Additional costs for tax administrations

In general the replies to the questionnaire in respect of the additional costs for tax administrations were poor. Out of the 27 Member States, only 23 replied to the questionnaire. Of the 23 Member States that replied, 17 Member States were unable to provide any figures on the extra costs for tax administrations. Thus, only six Member States provided some figures on the additional costs for the tax administration.

Nevertheless, from the replies given, the costs to the tax administrations vary from about €300 000 for a small Member State to €2 500 000 for a large Member State. This is in relation to the costs for providing trader information, training of staff, recruitment of new staff, changes to the control system and adaptation of the IT structure.

However, it would be inappropriate at this stage to draw any meaningful conclusions from these figures. They can at best be described as indicative.

2.6.3. Conclusion

The concept of taxing intra-Community supplies in the country of supply calls for additional obligations on the taxable person making the intra-Community acquisition, in order to provide for the necessary input for microeconomic clearing. The Commission is convinced that it would not be necessary to have very detailed reporting, given that the concept of VAT control is marked by self-assessment with subsequent *ex post* control. It would therefore argue that an obligation of monthly global recapitulative statements for acquisitions and supplies should suffice.

The information on the cost to tax administration is not sufficient for the Commission to be able to draw any conclusions. Such cost may also depend on further details to be specified regarding the functioning of the clearing system.

2.7. Impact of clearing on Member States' budgets

Those Member States in which the total amount of intra-Community supplies exceeds the total amount of intra-Community acquisitions could be considered to be "net contributors". Similarly, those Member States where the amount of intra-Community acquisitions exceeds the intra-Community supplies could be considered to be "net receivers". In this context, "net contributors" would mean those Member States that have to pay more **to** other Member States than they would receive **from** other Member States; and vice versa for "net receivers".

On the basis of the trade statistics for 2006 (see Annex 5.1) it appears that 16 Member States, under a system of taxed intra-Community supplies, would be "net receivers". Eleven Member States would be "net contributors". This is, however, a rather limited view on the basis of aggregated figures. In reality, most Member States will be both "net receivers" and "net contributors" — depending on the individual bilateral trade balance between two respective Member States.

This clearly means that in a clearing system any Member State becomes dependent on other Member States' payments but, obviously, Member States that are overall "net receivers" will be even more dependent on other Member States. The levels of trade involved make it extremely important that Member States are committed to ensuring that the amounts are not only correctly collected, but are also passed on where necessary. Net receivers had a negative balance of just over €200bn in 2006, which means that they would be relying on other Member States to collect VAT of around €30bn for them. In addition, the largest net contributors, Germany and the Netherlands, would find that they would be required to collect and distribute a large proportion of the intra-Community VAT.

The total amount of excess of acquisitions (imports) over supplies (exports) — the trade balance — was of the order of €80 billion in 2006. This discrepancy from what should in essence be zero (because intra-Community trade is within a closed market and one Member State's deficit is another's surplus) can be explained by a number of reasons. These include the level of estimation by Member States of non-submitted returns; the timing of the returns; errors on the returns; thresholds under which statements are not required; territorial issues; and the inclusion of goods for onward processing. Whilst this level of discrepancy may cause concern as an indication of the possible level of mismatches within the clearing system, nevertheless, for the majority of Member States the value of intra-Community supplies is between 10% and 20% of total supplies, meaning that 80% or more of current national VAT receipts would not be affected.

To avoid any disruption of VAT collection in Member States, it would be necessary to organise continuous transfers between Member States that can either be preliminary settlements on the basis of the recapitulative statements or can take the form of advanced payments of agreed amounts based on trade balances in the past. At least once per year, however, a final balance should be agreed.

2.8. Allocation of responsibilities and risks between Member States

Given an amount of €30 billion to be paid between Member States, the allocation of responsibilities and risks between the Member State of supply, where the tax is to be paid to the administration, and the Member State of intra-Community acquisition where, subsequently, tax is deducted, becomes essential.

2.8.1. Earlier work on a Clearing System

In understanding the issues in how a Clearing System would work, thought should be given to previous work. In this regard, prior to the completion of the Single Market, the Commission issued a Communication (Com (87) 323 final/2) on 25 August 1987 entitled "Completing the internal market — the introduction of a VAT clearing system for intra-Community supplies". However, there are certain key differences between that proposal and what is being considered now.

The Clearing System as described in 1987 was based on taxable persons declaring the amount of VAT on intra-Community supplies and the amount of VAT deducted on intra-Community purchases. In effect it was stated that “each registered trader will simply fill in two extra boxes on his normal declaration indicating his output and input VAT on intra-Community trade as a whole.” Consequentially, VAT not deducted would accrue as a surplus to the Clearing System. Furthermore, a listing of individual traders’ activities was rejected as it was stated that this “provides neither an adequate nor a suitable form of control over the revenue flows involved in the Clearing System.”

In the 1987 Communication on the Clearing System, the Commission was allocated certain tasks. Amongst these was the responsibility for the accounting and operation of the clearing mechanism and analysis of the data. This role was deemed necessary as Member States would establish their position in relation to intra-Community supplies and purchases and make a single payment or a request for refund from the Clearing System. In the new Clearing System, the clearing mechanism would be based on bilateral transfers between Member States and the role of the Commission in managing the system is not needed.

Furthermore, unlike the earlier Clearing System, the new Clearing System is based on trader listings. Moreover, as the intra-Community supplies will have a uniform 15% VAT rate, it is not based on VAT amounts but on the value of the transactions, allowing for a theoretical balance, rather than a surplus, in a Clearing System.

The 1987 Communication did recognise the need for control measures as the VAT amounts involved were large and the risk of fraud and trader errors needed to be addressed. These measures included clearly defined audit requirements, intensified administrative cooperation, greater use of agreed sampling techniques and credibility checks, and central coordination. There was also mention of arbitration in case of disputes between Member States. These issues would need to be looked at again under a new Clearing System.

Unfortunately, the 1987 paper did not provide sufficient detail on the control issues and indeed recognised that the level of detail would need to be “developed in the course of subsequent discussion”.

So whilst the Clearing System proposed in 1987 is useful as guidance regarding certain recurring themes it is also sufficiently different to the extent that issues pertinent 20 years ago no longer have the same relevance. A point in question is trader listings, which since 1993 have been a common feature of recording intra-Community transactions but which were disregarded back in 1987, although subsequent discussions did look more favourably on trader listings.

Work on a Clearing System came to prominence again in 1996 when the Commission was working towards a definitive system of VAT based on the origin principle. For this a system of macroeconomic reallocation of VAT revenues was suggested. This, though, has little relevance since the Clearing System described in respect of taxing intra-Community supplies is based on a micromodel of trader declarations.

What should be emphasised, and indeed has remained a recurrent theme throughout, is the need for enhanced cooperation between Member States. Whatever the details of a Clearing System, and there have been many variants and suggestions over the years, a fundamental cornerstone to it working effectively is the cooperation between Member States.

2.8.2. *Basic principle*

As a basic principle, it should be the responsibility of the tax administration of the Member State of supply to collect the VAT from its supplier and to make a transfer via the clearing system to the tax administration where the intra-Community acquisition has taken place. This is an important point as the purchaser has a right to deduct when the tax becomes chargeable. The system would become unworkable if the Member State of acquisition granting — in a correct way — the right of deduction, would not be able to rely on the Member State of supply to pay over the VAT, irrespective of whether the VAT due could be collected or not. Restricting the clearing system to VAT that has been collected would imply that all risks, which the Member State of deduction is unable to control or assess, would be transferred to that Member State.

By way of example, a taxable person in Member State A would charge and collect VAT of 15% on an intra-Community supply to a taxable person in Member State B. The taxable person in Member State A declares the VAT on his domestic VAT return and pays the amount due to his tax authority. The tax authority in Member State A receives from the taxable person in Member State A a recapitulative statement detailing the intra-Community supplies. Based on the recapitulative statements VAT is remitted to Member State B from Member State A. The taxable person in Member State B is allowed a right of deduction on his domestic VAT return in relation to his intra-Community acquisition. He will also be required to submit a declaration showing all his intra-Community purchases.

The Clearing System can thus be seen in three distinct stages:

- The first stage is the exchange of information. The Member State of supply, as is the case today, will submit information obtained from the recapitulative statements. The Member State of acquisition will likewise submit the information on the intra-Community purchases for the same period and with an equivalent level of detail.

- The second stage is the transfer of money. The recapitulative statements from the Member States of supply will be netted off and the balance will be paid over by the Member State with the higher intra-Community supplies.

- The final stage is the evaluation of and resolution of mismatches. As there will be recapitulative statements both on intra-Community supplies and purchases, Member States will have the opportunity to reconcile the data.

The following provides more detail on these aspects.

2.8.3. *Information used*

In determining the VAT due for intra-Community supplies and corresponding deduction claims, the Member States will base themselves on information received from taxable persons involved in taxed intra-Community supplies and acquisitions. This will include the current recapitulative statement for intra-Community supplies along with a new declaration from the recipient of intra-Community supplies. Both statements will be monthly and in theory should match.

In their own interest, Member States will control the information received according to the usual standards and they shall exchange recapitulative statements between themselves in order to have the same basic information. Furthermore, they may use, where needed, administrative cooperation in the usual way.

2.8.4. *Remittance through a bilateral Clearing System*

The Commission is of the opinion that the clearing should be operated in a purely bilateral relationship that opens the possibilities for Member States to agree on any detail of importance, taking into account their individual balance of trade, similarities of operating the VAT system and their control mechanisms, mutual trust and any other circumstance they would judge to be of importance. However, to offer guidance and to suggest solutions in the absence of individual agreements, the Commission estimates that the distribution of risk should be set in such a way as to foster the interest of each Member State to control relevant information in the best possible way, and, especially, to combat fraud as efficiently as possible.

The rules on the transfers via a bilateral Clearing System, whilst allowing Member States some degree of flexibility, should nevertheless be underpinned by a common framework with clear guidelines. The Commission has not yet finalised the intricate details of the working of the clearing system. Yet it is clear that in order to avoid budgetary deficits, the first payment would need to be made between Member States very soon after the reference month and a “final” settlement of the balance would need to be established at other appropriate intervals of six and 12 months.

2.8.5. *Mismatches*

Mismatches can result from different factors such as any unintended errors as well as fraud.

In theory, mismatches due to timing differences should not occur. Taxable persons making intra-Community supplies are subject to a common rule on the chargeability of tax[8] and the right to deduct arises at the same time, namely when the tax becomes chargeable. However, as Member States do not have a common understanding on chargeability to tax, it is inevitable that mismatches will occur due to timing differences. Nevertheless, timing differences will, by definition, only be of a temporary nature.

Member States will want to investigate other major mismatches as they are expected to do under the current system in order to eliminate them. These mismatches will

[8] Article 67 of VAT Directive 2006/112/EC.

arise, in simple terms, when the taxable person in the Member State of supply and the taxable person in the Member State of acquisition are providing different information. In the first stage the Member States should bilaterally try to establish the reason for the mismatch through, for instance, contact with the taxable persons concerned to establish the facts. A significant number of mismatches should be resolved this way.

Indeed, the self-policing nature of the fractionated VAT system should of itself provide reassurance. A taxable person will need to hold a valid invoice[9] to claim a right of deduction. The invoice, through accepted audit controls, should be supported by other documentary evidence such as a purchase order, a goods transit document, updated stock records, payment to the supplier, onward supply of the goods, etc. Much of this information can be checked against the supplier or with third parties.

2.8.6. Distribution of risks

Nevertheless, there will remain a number of cases where Member States are unable to determine what the reasons of mismatches are and, consequently, which Member State bears direct responsibility for the revenue. Since the collection of VAT is a competence of the Member States, the allocation of those receipts should remain under their competence and, therefore, any system should be run and organised by the Member States themselves.

Lack of revenue to cover the claims of the VAT deduction allowed in the Member State of acquisition can always have its source in both Member States: either the Member State of supply has not collected enough of the VAT due (supply not correctly classified as intra-Community supply, insolvency, missing trader) or the Member State of acquisition has accepted VAT claims that were not justified.

The exact composition and rules of procedure of any system would need to be gone into during further discussions. The aim, though, must be to reach a binding decision on whether, on the basis of the presented facts, a Member State has an obligation to remit money to another Member State through the Clearing System.

2.8.7. Conclusion

The clearing should be organised bilaterally to take into account specific situations and to limit as much as possible unnecessary administrative work and cost. Member States should base themselves on the recapitulative statements they receive from taxable persons to establish their clearing position and to create the necessary framework for control and cooperation. Each Member State will bear the risk of what he is responsible for, but where lack of revenue cannot be attributed to a specific reason, Member States should bear such risk equally.

2.9. Conclusion on taxation of intra-Community supplies

The Commission remains convinced that the taxation of intra-Community supplies of goods would contribute effectively to a solution to the problem of MTIC fraud. It recognises, however, that such a system also might increase proportionally other

[9] Article 178 of VAT Directive 2006/112/EC.

already well known types of VAT fraud and expresses some concern as to the effects of the cash-flow consequences for businesses and in particular for SMEs — it might be worth investigating this issue further.

The Commission is convinced that there would not be any insurmountable technical problem in putting a microeconomic and bilaterally organised clearing system in place.

However, the fundamental question which needs to be answered is whether or not Member States could accept a concept that would make them dependent on each other for some 10% of their VAT receipts.

3. REVERSE CHARGE

In a traditional VAT system, the supplier charges and pays to the Treasury VAT in respect of supplies of goods and services within a Member State. If the customer is a (normal) taxable person, then he can recover the VAT charged by claiming it back on his VAT declaration. This results in a system of fractionated payment, whereby the VAT on the final price to the final consumer is paid to the Treasury by different taxable persons in the supply chain in direct proportion to their ‘value added’. This interplay of VAT payment on supplies and VAT deduction on purchases is traditionally considered as the main feature of VAT, providing for an in-built, largely self-policing control mechanism.

In a reverse-charge system, VAT is accounted for by the taxable customer instead of the supplier. As the customer, in so far as he is entitled to full deduction, deducts this VAT on the same VAT declaration, the net result is nil and no payment is to be made. The reverse charge is not applied to supplies to private individuals and the supplier has, in that case, to charge and pay to the Treasury the total amount of VAT. There is no fractionated payment in a reverse-charge system as the total VAT is paid only at the end of the supply chain.

Reverse charge can in theory be applied to all Business to Business (B2B) supplies. However, in its conclusions of June 2007, the Council specified that under the general reverse-charge system the Commission was invited to analyse, a threshold would be set at €5 000. This threshold applies for each individual transaction.

Under such a system, a taxable person will for all his domestic supplies firstly have to verify the status of his customer. When the customer does not qualify for the application of the reverse charge (mainly private persons but also non-taxable legal persons and fully exempt taxable persons) the supplier will have to charge VAT to his customer.

When the customer is a taxable person qualifying for application of the reverse charge, the supplier will have to verify the amount of the transaction.

When the taxable amount of the supply is less then €5 000, the supplier would have to charge VAT to his customer. The business customer can deduct this VAT under the normal rules.

When the taxable amount of the supply is equal to or above €5 000, the supplier will not charge VAT on the supply. The business customer will account for the VAT on this supply and will be able to deduct this VAT under the normal rules.

The introduction of a generalised reverse-charge system does not affect the rules for taxation of intra-community transactions, nor should it in principle have any bearing on transactions with third countries; it only affects the rules for taxation of domestic supplies of goods and services.

Whilst the system of taxation of intra-Community supplies of goods only affects businesses carrying out this type of transaction, which seem to be around 9% of the taxable persons within the EU, it is likely that a much larger proportion of taxable persons would be affected by the introduction of a general reverse-charge system.

Indeed, even taxable persons mainly dealing with private consumers, and therefore not applying the reverse charge on the supplies they make, will be confronted with the reverse-charge system when making purchases above the threshold.

3.1. Risks of new forms of fraud resulting from the use of a reverse-charge system on an optional basis

3.1.1. Methodology

The Commission invited an external consultant to carry out an independent study to explore the risk of new forms of VAT fraud deriving from the use of a general reverse-charge system on an optional basis for transactions within a Member State, where the threshold per invoice amount is set at €5 000.

Besides describing the new forms of fraud which had been identified, the consultant was asked to examine the likelihood of occurrence of those new forms of fraud, identify mitigation measures and evaluate their potential impact in tackling fraud.

Since the study could not be based on existing experiences with the VAT model, it was instead based on workshops with experts in VAT and forensic auditing from the consultant and also external experts such as specialist lawyers and tax investigation officials.

3.1.2. Main findings of the study

There are three main features of the proposed reverse-charge system which are the factors triggering the newly identified forms of fraud:

- the possibility to acquire goods free of VAT;
- the provision of a threshold;
- the optional character of the reverse-charge system.

Based on these three factors, the study comes to the conclusion that the following, already existing fraud patterns will be the most likely to increase:

- concentration of fraud at the retail level since it is at that level that the whole VAT-collection process will occur. The potential loss of VAT revenue at that stage of distribution could in absolute terms be higher compared to the current system, as the tax authorities will need to concentrate their audits at the retail level, which traditionally comprises economic operators that are more difficult to audit due to their number, their dimension and their status;

- hijacking of VAT identification numbers (by pure holdings, sham companies, non-established taxable persons, end consumers). This type of fraud can be committed in order to avoid paying VAT but it could also be used for entering goods into the black market. The reverse charge could increase the gain for the fraudster and allow him to distribute goods at a lower, and therefore more attractive, price (see last point);

- abuse by pure holdings of their own, valid VAT Identification number;

- migration of missing-trader fraud to Member States not implementing the reverse charge and having a high VAT rate;

- creation of fake invoices to lower a (high) payment position (the reverse charge generates no input VAT);

- replication of MTIC patterns in a purely domestic scenario;

- easier access of goods to national (and cross-border) black markets and at a more attractive price.

Moreover, the following newly identified methodologies could be used to create fraud schemes in the context of reverse charge:

- direct or disguised artificial splitting of the taxable amount of a transaction in order to circumvent the threshold;

- migration of artificial splitting to other Member States that have implemented the reverse-charge system and that apply a high VAT rate.

The objective of such artificial splitting mechanisms would be to create a situation whereby a fraudster can buy goods "VAT-free" under the reverse-charge mechanism and consequently charge VAT on the onward supplies made for the amounts under the threshold; this trader then goes missing and does not pay VAT over to the Treasury.

Looking at the mitigation measures, the study shows that only the interaction of several methodologies is likely to be effective in mitigating the risk of VAT fraud under the reverse charge.

In particular, the measures suggested by the consultant for effectively combating all the (new) forms of fraud under a domestic reverse-charge system would be:

- to implement a mandatory reverse-charge mechanism in all Member States;

- no invoice threshold, but if there was to be one, it should be lower than €5 000;

- to implement monthly sales and purchase listings for all domestic transactions, not only for the transactions under the reverse charge but also for the transactions under the threshold with a view to detecting the artificial splitting of the taxable amount;

- to use a specific identification for taxable persons qualifying for making purchases under the reverse-charge system;

- to implement new data-mining tools and new risk indicators;

- to improve the registration rules, possibly with de-registration and a new registration exercise;

- to improve exchanges of information between Member States;

- to introduce a computerised taxable person's identity card showing that the taxable person is a *bona fide* trader.

The study comes to the conclusion that protecting the application of a reverse-charge system against new risks of fraud would require implementation of burdensome measures, since it would create the need to monitor on a real-time basis not only cross-border supplies but also — to a large extent — purely domestic ones.

Finally, for the authorities, the system would require a more effective and responsive strategy (e.g. exchanges of information and close cooperation) and the implementation of new and more modern solutions such as data analysis, data-mining, predictive modelling, profiling, electronic VAT IDs, "R" numbers, etc.

3.1.3. Comments

General Comments

The study identified a number of new risks of fraud as well as a number of fraud patterns already existing today which might be facilitated by the introduction of a generalised reverse-charge system on an optional basis and with application of a €5 000 threshold.

The main risks clearly are the abuse/misuse of VAT identification numbers and increased tax losses at the retail level. This last point is also very much emphasised by a Portuguese study which was based on a rather specific high proportion of small businesses in Portugal subject to specific tax rules.

The Commission would like to point out that it was in the current context impossible to ask for any estimates of the potential losses resulting from the new risks of fraud. This would require a substantial economic exercise for which too many factors are unknown at this stage.

Finally, the Commission notes that some of the mitigation measures suggested by the consultant, and in particular those which do not put additional burdens on businesses (to implement new data-mining tools and new risk indicators; to improve the registration rules, to improve exchanges of information between Member States), are not specific to an optional reverse-charge system but are equally important within the current VAT arrangements.

Specific comments on the reporting obligations

The potential of certain types of fraud, in particular the hijacking of VAT ID numbers and the creation of fake invoices, will largely depend on the possibilities for their early detection by the tax administrations.

The reporting requirements to be imposed under a reverse-charge concept constitute a key aspect of the mitigation measures.

The level of detail laid down for the reporting obligations imposed both on the supplier and the customer would largely influence the way the tax authorities could verify the correct use of the reverse-charge system.

(a) No additional reporting obligations

Information obtained periodically by the tax administration:

- from the supplier: the global amount of supplies made under the reverse-charge system by the supplier via the VAT return;
- from the acquirer: the global amount of VAT due as a result of the reverse-charge system and possibly the global amount of purchases made under the reverse-charge system via the VAT return.

In this case, there would be **no possibility for any initial verification** by the tax administration at the time of submission of the VAT returns.

Verification could not be done in a systematic way but only as part of a normal audit. Such a system would provide fraud opportunities. Fraudsters could buy goods and services without pre-financing the tax and make consequent supplies on the black market. It would be sufficient to declare artificial sales under the reverse-charge system on the VAT returns. By doing so, the VAT returns would look trustworthy at first sight and the fraud could be masked for a long period.

(b) Periodical global listing from the supplier, no additional reporting from the acquirer

Information obtained periodically by the tax administration:

- from the supplier: a listing containing the VAT number of the acquirer and the global value of supplies made to that acquirer for a given period (month, quarter);
- from the acquirer: the global amount of VAT due as a result of the reverse-charge system and possibly the global amount of purchases made under the reverse-charge system via the VAT return.

This information **would allow some basic checks** to be carried out at the time of receipt of the VAT returns and listing.

Firstly, the global amount of reverse-charge supplies declared by the supplier in his VAT return should correspond to the total amount of supplies declared in the listing. When reverse-charge supplies were declared in the VAT return but no listing were submitted, it could be an indication of sales wrongly declared as reverse-charge supplies.

Secondly, and more important, a **rudimentary "cross checking" would be possible.** The total amount of supplies declared to an individual acquirer can be compared with the global amount of acquisitions the acquirer declared in his VAT return.

This cross-checking can only reveal mismatches; it does not make it possible to identify the source of them.

The acquirer will be the target of the tax administration investigating the reasons for the mismatch.

If the acquirer declares an amount of acquisitions under reverse charge higher than the amount resulting from the suppliers' listing, the acquirer will have to provide all the details of his acquisitions to the tax administration. The tax administration requires this information in order to detect the suppliers which have not mentioned the acquirer on their listing or have mentioned him but for too low an amount.

It is only after the tax administrations have compared the data from the listings with the more detailed data obtained from the acquirer that the tax administration can carry out the second step in the verification process, which is checking with the suppliers the reasons for the mismatch.

If the acquirer declares an amount of acquisitions under reverse charge lower than the amount resulting from the suppliers' listing, the acquirer will again have to provide all the details of his acquisitions to the tax administration.

After comparing the data, the tax administration will have to examine the reasons for mismatches. If the acquirer denies having received certain supplies, the tax administration will have to check with the supplier the validity of the reverse-charge supplies.

Companies with a lot of suppliers (distribution sector, for example) have an increased risk for mismatches due to negligence by the suppliers, material errors, etc. These companies run the risk of being constantly bothered by the tax administrations examining those mismatches.

(c) Periodical global listing from the supplier, periodical global listing from the acquirer

Information obtained periodically by the tax administration, apart from the VAT return:

- from the supplier: a listing containing the VAT identification number of the acquirer and the global value of supplies made to that acquirer for a given period (month, quarter);

- from the acquirer: a listing containing the VAT identification number of the supplier and the global value of supplies made by that supplier to that acquirer for a given period (month, quarter).

Firstly, there is a **possibility to cross-check the VAT return data** and the listings, both from the supplier and the acquirer.

This information would also provide the tax administration with an **indication of the source of the mismatch.** In fact, the first step mentioned in the previous system (collection of the data from the acquirer) would no longer be necessary.

The tax administration would still have to investigate, both with regard to the supplier and the acquirer, the reasons for the mismatch.

(d) Transaction-based listing from the supplier, no additional reporting from the acquirer

Information obtained periodically by the tax administration:

- from the supplier: apart from the VAT return, a listing containing for each reverse-charge transaction the VAT number of the acquirer and the taxable amount;

- from the acquirer: in the VAT return the global amount of VAT due as a result of the reverse-charge system and possibly the global amount of purchases made under the reverse-charge system

Although the tax administration would obtain more detailed information from the supplier, it seems that this possibility would have few advantages compared to the system set out in point b above.

Indeed, **only rudimentary cross-checking is possible** with the VAT return from the acquirer, and additional information will have to be asked from him when the tax administrations want to investigate the reasons for the mismatch.

Therefore, requesting transaction-based information from the supplier does not speed up the process by comparison with the global-listing reporting in the first stage, since additional information will need to be requested and obtained from the acquirer so as to detect the reasons of the mismatch.

Having transaction-based information directly available within the tax administration might facilitate the cross-checking process itself.

(e) Transaction-based listing from the supplier, periodical global listing from the acquirer

Information obtained periodically by the tax administration, apart from the VAT return:

- from the supplier: a listing containing for each reverse-charge transaction the VAT number of the acquirer and the taxable amount;

- from the acquirer: a listing containing the VAT number of the supplier and the global value of supplies made by each supplier to that acquirer for a given period (month, quarter).

This information would enable the tax administration to cross-check and obtain an indication of the source of the mismatch.

The tax administration would still have to ask for more detailed information from the acquirer in order to detect the reasons for the mismatch but only for the transactions for which the cross-checking does not tally.

(f) Transaction-based listing from the supplier, transaction-based listing from the acquirer

Information obtained periodically by the tax administration, apart from the VAT return:

- from the supplier: a listing containing for each reverse-charge transaction the VAT number of the acquirer and the taxable amount;

- from the acquirer: a listing containing for each reverse-charge transaction the VAT number of the supplier and the taxable amount.

This information would enable the tax administration **to undertake exhaustive cross-checking and would give quite a clear indication of the origin of the mismatch** (the reason for it would need to be further investigated).

Comparing the different results, it becomes clear that minimum reporting requirements should satisfy (c), (e) or (f) and allow for quick and efficient control.

It should be pointed out that the above analysis is made from a theoretical control-efficiency point of view. This aspect has to be considered in a broader perspective, notably taking into account the tax administrations' capacity to effectively analyse the mismatches and whether the costs for businesses resulting from these reporting obligations would be acceptable within the Lisbon Agenda context.

Specific comment on the threshold

The study suggests the elimination of the threshold in order to increase the robustness of the reverse-charge system. In the Commission's view, this might nevertheless have some adverse effects. Indeed, the lower the threshold is set (*in extremis* at zero) the more attractive the system becomes for the new fraud scenarios allowing the acquisition of goods free of VAT; the higher the threshold is set the more attractive becomes the organisation VAT-deduction-related fraud and in particular the replication of the MTIC pattern in the domestic scenario. The Commission is therefore of the opinion that the threshold of €5 000 retained by ECOFIN for the further analysis should not be placed in question.

3.1.4. *Conclusion*

The Commission considers that so far no real experience with a generalised reverse-charge system exists that could confirm or contest the more theoretical findings of the study — even using the knowledge of experienced VAT experts.

Therefore, the Commission cannot come to a clear conclusion on whether the new frauds which would be possible as a result of reverse charge would result in a greater or a lesser loss to Member States' Treasuries than that which they currently face as a result of MTIC fraud. What is very clear, is that the scale of MTIC fraud would be substantially reduced as a result of introducing a reverse charge with a limit per invoice, because fraudsters would then have to split invoices many times to achieve the same result.

On the other hand, the black economy forms a major part of non-collected VAT. The important question remains as to whether, compared to the current system, the introduction of a reverse-charge system would facilitate the deviation of goods from the official circuit to the black market or not, and if the loss of VAT due to such deviation would be greater under the reverse-charge system compared to the current system.

3.2. Costs for taxpayers and administrations

3.2.1. *The costs for taxable persons*

3.2.1.1. Methodology

The Commission was of the opinion that to analyse the possible impact on businesses in terms of additional costs, it had to rely on the input provided by the taxpayers concerned.

The objective of the study was to explore the impact of a generalised reverse-charge mechanism with a sample of 20 companies in order to have an indication on the administrative costs (one-off and recurring costs) for businesses, the impact on their cash flow and the potential impact on their competitiveness within the internal market.

It should be pointed out that the very small sample used does not allow for any extrapolation of the costs for businesses within the EU. On the other hand, it was impossible within the short timeframe to request a more extensive study.

The study was followed by a public consultation launched on the TAXUD website whereby businesses were invited to submit to the Commission their reactions and contributions concerning the issues raised by the study. A total of 335 contributions were received in response. Of that total, 33 were from national and European federations or associations, 42 were from large, multinational businesses and 260 were from smaller, national traders, most of them based in Austria where the issue is highly topical.

Whereas the replies from SMEs' to a large extent came from all sectors and branches (manufactures, traders, service providers, construction sector, transport sector, food, HORECA, etc.), the replies from countries other than Austria represented mainly large, international operating enterprises and national or European trade and service associations.

The responses covered a wide range of industry and business sectors. The main sectors that responded were consultants, accountants and law firms, trade, the construction sector, engineering, electronics and IT sectors, the transport sector, industry, the metal and steel sectors, and the food and HORECA sector.

3.2.1.2. Main findings of the study and analysis of the responses to the public consultation

(1) Impact on administrative costs and additional burdens

The consultant came to the conclusion that introducing a reverse-charge mechanism would lead to both additional one-off and recurring administrative costs. The obligation to issue compliant sales invoices is by far the most costly formal obligation. This is mainly due to the requirement to apply the reverse charge only to transactions exceeding a specified threshold. Applying such a threshold is costly to automate and leads to manual processing of exceptions.

The highest recurring costs are caused by the obligation to file a general purchase and sales listing electronically, the obligation to issue compliant sales invoices and the obligation to register purchase invoices correctly. The recurring burden appears relatively high for small and medium-sized companies because these companies still rely heavily on manual processes, which leaves a lot of room for errors and hence there is a need for either upfront control or time spent making corrections.

The replies received in the context of the public consultation largely confirmed that a high amount of one-off costs would arise due to the necessary changes and adaptation of the IT systems and corresponding costs, such as identification of status for all clients and customers, changing administrative and organisational procedures, training staff, additional reporting obligations, etc.

Recurring costs would arise due to additional listing and reporting obligations (and respective record-keeping requirements) and the initial and ongoing verification and monitoring of the status of each customer. Application of the threshold and identification of customer status were identified as the most costly aspects of a general reverse-charge system.

Concerning explicit cost estimates and figures, most replies said that estimates would not be possible before more details on the envisaged legal provisions and the respective administrative obligations for traders became available. However, several respondents provided figures, analysis of which shows that these vary a lot and would be difficult to collate meaningfully.

In any case most of the respondents expect rather high additional costs and administrative burdens and therefore consider that from the view of cost/benefit the measure would not be efficient or even proportionate.

(2) Impact on cash flow and cross-border competitiveness

The study indicated that the cash-flow impact mainly depends on the company's business model and is influenced by the company's import/export situation as well as payment lead times with regard to both suppliers and customers.

The public consultation confirmed that the impact on cash flow varies greatly, and strongly depends on the place of the business in the supply chain, the volume of its purchases and sales and its terms of payment and negotiating power. On average, there seems to be a positive cash-flow impact due to the fact that input VAT would no longer have to be pre-financed. However, this would not level out the additional administrative costs.

(3) Any other impact (cost and/or benefit) and further comments

It was mentioned that the increased complexity of the VAT system arising from a reverse-charge mechanism would probably lead to a higher number of accidental reporting mistakes or data mismatches and to the potential risk of being held liable for VAT in cases where customer identifications turn out to be wrong. This leads to the demand to impose clear legal provisions, simple reporting obligations and a high level of legal certainty for traders in respect of identification and monitoring of customer status.

Traders who carry out business activities in several Member States emphasised that the introduction of a general reverse-charge system on an optional basis would be extremely problematic, since they would have to cope with different systems in different Member States. This would lead to a significant lower level of harmonisation and would negatively influence and burden their cross-border activities.

(4) Conclusion

The majority of respondents were very sceptical about the proposed changes in the VAT system with respect to introducing a general reverse-charge system on an optional basis. However, there were also a reasonable number of respondents who said they could agree with the proposed changes or were even in favour of it. Around 20% of the replies saw certain advantages arising from a general reverse-charge mechanism. However, most of these positive replies stated that the reverse-charge mechanism should only be introduced without a threshold and be made compulsory for all Member States. Otherwise, traders would be faced with two different systems on a national and an EU level, which would negatively influence their cross-border activities and the functioning of the internal market.

It became clear that businesses were strongly concerned about increased complexity and a step being taken backwards from harmonisation of the VAT system. Any new administrative burden on legitimate business would only be accepted if it were absolutely essential and efficient in the fight against VAT fraud. In addition, any change introduced should be clearly structured, simple to operate and the rules should be consistent across all Member States.

3.2.2. *The costs for tax administrations*

3.2.2.1. Methodology

The Commission was of the opinion that only the tax authorities themselves could provide relevant data for analysis of this issue.

A number of questions were therefore addressed to the Member States in order to determine the actual running costs of managing the current VAT system and an obtain an estimate of the costs for running the VAT system under a general reverse-charge mechanism.

In particular, Member States were asked to indicate what would be the effect of implementing the reverse charge on different types of cost such as publication costs for the trader population, training existing staff, taking on additional staff, changing the control system, adapting the IT structure and transition costs. Moreover, Member States were asked to estimate the potential impact on the cash flow in the year of introduction and the estimated impact resulting from the change in collection patterns (more VAT to be collected from retailers under the reverse-charge system).

The questionnaire was sent to all Member States. Only 23 Member States replied to it.

Of these:

- seven Member States did not provide any information about the total yearly running costs of managing the current VAT system;
- another seven Member States did not reply to the question on the estimated costs under the reverse-charge system.

Moreover, several Member States provided general answers to the questions about the costs (or only to some of them) without indicating figures.

On the basis of this fragmented information, the Commission is not in a position to provide a solid analysis of this aspect raised by the Council. The comments below reflect what the Commission was able to draw on from the input received from the Member States.

3.2.2.2. Analysis of the responses to the questionnaire

(1) General observation

It needs to be borne in mind that, regardless of the introduction of the reverse-charge system, the yearly running costs of managing the current VAT system or tax system in general (data referring to 2005 and 2006) increased by less than **1%** on average in all Member States (except for one Member State where running costs decreased).

Based on the replies provided by the Member States, the Commission has tried to make a very rough estimate of the average cost for the tax administration related to introduction of the reverse-charge system.

The estimated costs in the first year of introduction of the reverse-charge system represent, on average, about **21%** of the total running costs of managing the current VAT system.

For calculating this EU average, only the answers of Member States which indicated figures (only eight Member States) could be taken into account.

Moreover, this percentage actually has to be considered to be rather conservative because some of these eight Member States only provided a partial reply, indicating figures for some but not for all costs involved (although they recognise the relevance of them).

The Commission would like to stress the indicative character of the estimate, due to the fact that the data available are not sufficient to make a calculation which is sufficiently solid from a statistical point of view.

(2) More detailed comments

(a) On the costs

All Member States which provided input estimate that the introduction of a generalised reverse-charge system will generate additional costs for the tax authorities in the year of introduction. In general the most important costs are publication costs for the trader population and costs for training and taking on additional staff.

Two Member States indicated that they predicted a reduction of the burden of the tax administration in the long run, since control of input-tax deduction would be improved and facilitated considerably. Moreover, the risk of MTIC fraud would be eliminated. This factor should have a positive impact on the tax administration's running costs in managing the VAT system.

While three Member States did not provide an estimate of the additional costs, they referred to previous experience, notably with the introduction of sectorial reverse-charge applications in their country, to make clear that there will be a cost.

Most remarks concern one-off costs, with adaptation of IT structure, training of existing staff and publication costs being those most cited. Changing the tax administrations' control system seemed to be considered less problematic.

Recurring costs following the implementation of the reverse-charge system were in general not commented upon.

(b) Impact on cash flow

Whilst one Member State predicted a cash-flow benefit resulting from the introduction of the reverse-charge system, a number of other Member States estimate significant cash-flow loss in the year the reverse charge is introduced. Two Member States predicted a loss which they found to be difficult to evaluate at this stage. The majority of Member States did not comment on this specific point.

The Commission notes that neither those Member States expecting a positive cash-flow benefit nor those predicting a negative benefit clearly explained in their replies how they arrived at that conclusion. In the Commission's view, there should not be any major cash-flow effect for the Treasury as, on the one hand, there may be some advantage from the elimination of VAT deduction before payment whereas, on the other hand, there might be a small timing effect as to the time lag until VAT is paid at the final stage of retail.

(c) Change in the collection patterns

Two Member States did not think there would be any problems since the total VAT amount paid by the whole supply chain would be the same. The difference would be that under the reverse-charge system the retailer would pay the total VAT amount to the State whilst under the current system he would pay VAT both to the supplier and the State. One of these Member States posited that tax collection should improve since more detailed information would be available about the purchases made by the retailer.

A number of Member States expressed concerns about the change in collection patterns. Member States indicated that tax fraud was expected to move to the retail-sale level, since the reverse-charge system does not eliminate fraud at this stage of the delivery chain and merely moves the risk of fraud to that final stage. It should be noted that the producer of goods, the main "source" of budget revenues in the current system, rarely "vanishes". Transfer of the liability for payment of VAT to the purchaser eliminates this "sure source" of revenue.

In addition it was pointed out that a large part of the collected VAT would move from the intermediary stages of the production and distribution chain of goods and services to the last stage — direct contact with the final consumer. There is a large number of very small businesses at this stage which are difficult — and expensive — to control. Due to that dissemination effect in VAT collection, a disproportionate increase in the running costs for managing the VAT system and greater difficulties in collecting the tax are to be expected.

One Member State has signalled that it had carried out a detailed econometric study of the possible imposition of a general reverse charge, and while the conclusion from that study was that the introduction of reverse charging would result in only a small loss of revenue, what was more disturbing was the way the tax receipts would become dependent on businesses operating in areas which are historically difficult to control. In this Member State, it was notable than more than 30% of the VAT paid into the Treasury was paid by less than 1% of all taxable persons. The study also demonstrates that in this specific Member State the contribution — in the form of payments of VAT made to the Treasury — from large taxpayers is reduced from 47% of the total VAT revenue to 25% of the total under the reverse-charge system. The contribution from small taxpayers under a reverse-charge system would increase from 1% to 33% of total VAT revenue.

So while at first sight there is theoretically almost no loss/gain in VAT receipts, the continuation of this situation would be directly proportional to the amount of effort tax administrations invest in controlling the retailers who up to now were not key players in the context of VAT payments to the Treasury. This would, however, very much depend on the specific circumstances in an individual Member State.

(3) Other general remarks

Three Member States predicted a rise in costs and of legal proceedings linked to correct application of the new system. They do not believe there will be any budgetary benefit for the State.

3.2.3. Conclusion

On the basis of the input provided by the Member States, the Commission has come to the conclusion that the Council has asked them to analyse an aspect, namely the costs to administrative authorities of implementing a reverse-charge system, on which the Member States themselves do not have sufficient data available allowing them to provide the necessary input for such an analysis.

At a very general level, it can be concluded that all Member States predicted an additional cost at the time of introducing the reverse-charge system. However, two Member States are convinced this cost will be compensated by the advantages of the system once it is up and running.

The change in the collection patterns should in theory not affect the ultimate amount of VAT collected. Indeed, the VAT collected under the current system from the large taxpayers — which are mainly involved in B2B transactions — is deductible at the same time by the recipient of the goods or services. However, the fact that a relatively small number of taxpayers ensure — in their role as unpaid tax collectors — that a major part of VAT revenues effectively enters the Treasury in time and with little effort from the tax administrations is considered to be one of the VAT system's major advantages.

The Commission would like to point out that since Member States have the primary responsibility for managing the VAT system, the costs of managing that system are primarily their concern. However, in the end citizens, but also businesses, bear the cost of public services; therefore there is a link between the efficiency of a tax administration and the European policy of pursuing the Lisbon Agenda.

While reverse charge might, at first sight, appear to be seductive from a business perspective, particularly as firms would no longer have to pre-finance the VAT on their supplies, the reaction from business does not generally recognise this issue, which could be seen to be an advantage. Businesses rather highlighted the difficulty they perceive in complying with the ensuing obligations.

The study on the costs for business demonstrates that a change towards a reverse-charge system leads inevitably to additional costs for traders; business will therefore need to be convinced about the advantages of such a change.

Indeed, the study demonstrates that the main cost factor is ensuring compliance with two different sets of VAT rules for domestic transactions caused by the fact that reverse charge would only apply to transactions exceeding a specified threshold. Moreover, if an optional reverse charge were to be introduced within the EU, traders having economic activities in several Member States could also be confronted with substantially different VAT systems within the EU. Both situations are a major concern for businesses since any further degree of disharmonisation leads inevitably to additional costs.

The Commission supports businesses' desire to ensure that costs and unnecessary bureaucracy are kept to a minimum. It also understands their desire for legal certainty regarding transactions and fully shares the opinion that the introduction of additional complexities into the VAT system should be avoided.

3.3. Effects of a generalised reverse-charge system on other Member States

3.3.1. Methodology

The Commission was of the opinion that it would have to rely on the input from national tax authorities to analyse such effects. Firstly, they were invited to share their experiences in respect of the sectorial reverse-charge mechanism, based on Articles 194, 199 and 395 of the VAT Directive although the Commission is well aware that not all Member States had such experiences.

The questions addressed to the Member States about their experiences covered two aspects: on the one hand, the effects of application of a reverse-charge mechanism in another Member State and, on the other, the effects on the other Member States of introducing a reverse-charge mechanism at national level.

Secondly, Member States were also asked to share their expertise concerning the risk of fraud migration, as this issue has been raised on several occasions during the technical discussions on introduction of a generalised reverse-charge system. The Commission was interested in Member States' expertise in identifying potential fraud patterns in this area.

The questionnaire was sent to all Member States, 23 of which replied. While some Member States provided detailed responses, others were very brief (yes/no/not applicable) without further explanations; some questionnaires were even returned completely blank.

3.3.2. Analysis of responses

(1) Experiences of migration of fraud in the past as a result of the implementation of a reverse-charge mechanism in other Member States

Most Member States replied that they had not experienced in the past the phenomenon of migration of fraud as a result of the implementation of a reverse-charge mechanism in another Member State. In fact, only two Member States witnessed a migration of fraud due to implementation of a reverse-charge mechanism in a neighbouring Member State (one Member State in the scrap metal sector, one Member State in the investment gold sector experienced after it joined the EU). Both Member States implemented a reverse-charge mechanism in the sectors concerned in order to stop the migration of fraud.

The great majority of Member States indicated that in the current situation there is no (measurable) evidence of migration of fraud due to implementation of a reverse-charge mechanism. However, some of them pointed out that this does not mean that this phenomenon did not occur.

As a consequence, Member States did not have information regarding types of fraudulent activity, nor could they say that migration of fraud would be an essential factor when considering implementation of a reverse-charge mechanism in their own country.

A number of particular arguments were given as to why Member States have not experienced, to date, a migration of fraud due to the introduction of a reverse-charge mechanism or why there was an absence of this phenomenon:

- A specific investigation has never been carried out to that purpose.

- The short period since joining the Single Market by the new Member States.

- Since the reverse-charge mechanism implemented in the UK for computer components and mobile phones only came into force on 1 June 2007, the Member States are not yet aware of the possible effects of such implementation. This does not mean that the UK mechanism did not produce migration of fraud, and in the run-up to the derogation decision there were indeed very strong concerns leading to a more narrow scope than initially envisaged by the UK. It appears to be too early for the tax administrations to detect possible effects from the reverse-charge mechanism entering into force in the UK.

- For the previous derogations granted on the basis of Article 27 of the Sixth Directive (now Article 395 of the VAT Directive), the purpose of some of these derogations was not to prevent fraud but to simplify the collection of tax for the Member States. Furthermore, the scope was limited to particular activities/sectors with no direct output to the general public or retail level. As a consequence, there was no risk of false sales to the final consumer and limited risk that retail companies would disappear after collecting the VAT from final consumers. Moreover, after transformation of the products falling under the derogations, the subsequent transactions up to the final customer follow the normal rules of VAT collection.

- Some Member States emphasised that the scope of applicable reverse-charge systems in Member States at the moment only target specific or partial sectors and for some Member States almost exclusively in the services sector, where the place of taxation for such service is mainly situated on the spot and thus not movable. The risk of fraud migration and its extent are different, probably greater and wider in the generalised reverse-charge system which covers goods as well. Any comparison with a reverse-charge system in a Member State is therefore extremely distorted.

(2) Effects of the implementation of a reverse-charge mechanism at national level on the other Member States

Member States could not clearly indicate whether they had seen an increase in cross-border activities (suggesting untaxed goods moving to other Member States) in cases where they had implemented a national sectorial reverse-charge mechanism in their own country, nor could they clearly indicate whether they saw a relocation of business to other Member States after their country had implemented a domestic reverse-charge mechanism.

The Member States appeared to have no data available to support any other conclusion. The fact that some of the reverse-charge systems came into force only very recently and their limited scope may be a reason why the Member States had not yet noticed such a phenomenon.

One Member State believes that there is no carousel fraud anymore in the sector of investment gold, following the introduction of the reverse charge. Another Member State witnessed a decrease in the number of traders and also a decrease in the turnover after they introduced a reverse-charge mechanism in the scrap metal sector (but which only targets the beginning of the collection chain).

(3) Risk of fraud moving from a Member State applying the reverse-charge system to a Member State not applying it

(a) General

The Member States were asked whether they believed there is a real risk of fraud moving from a Member State applying the reverse charge to a Member State not applying it, and what kind of additional measures need to be implemented in the Member State applying reverse charge in order to reduce this risk.

Two Member States are of the opinion that there is no risk of fraud moving to other countries if the reverse-charge system is implemented with safeguards. The vast majority of the other Member States are of the opinion that there could be a real risk of fraud moving from a Member State applying the reverse-charge system to Member States not applying it. One further Member State pointed out that it depends on the economic sector, i.e. there is a real risk in the scrap metal sector.

(b) Potential risk(s) described by the Member States

A number of Member States also explained in detail why they think there is a higher risk of fraud moving if an (optional general) reverse-charge mechanism is implemented:

- Rerouting of the fraud traffic to other Member States where administrative resistance (audit/prosecution/penalties etc.) is perceived to be the least (nine Member States).

- Spreading of the fraud to a broader spectrum of commodities (not only mobile phones and CPUs), which makes it more difficult to set up precise risk profiles (two Member States) (only applicable to a targeted reverse charge).

- Difficulties in ensuring adequate administrative follow-up of the flow of goods operating through the Member States that apply the reverse-charge system (one Member State).

- Increased activity in the black economy due to a decrease in controls. In a reverse-charge system it is feared that supervision by the Member State that introduced the reverse charge will gradually erode. It will be focusing its control methods on its own retailers, from which the Member State obtains its income, instead of focusing on intra-Community trade. This deterioration of information will result in Member States being less well prepared to effectively fight against MTIC fraud (two Member States).

- There could by a shift to activities which do not fall under the reverse-charge mechanism (one Member State).

- The reverse-charge system could lead to more fictitious intra-Community transactions and thus more missing traders (one Member State).

(4) Additional measures to reduce the risk of migration of fraud

Member States were asked to indicate what accompanying measures would need to be implemented in a Member State deciding to apply the reverse charge in order to reduce the potential risk of migration of fraud.

One Member State considers that there is no need for additional measures because they do not see a risk. The Commission finds this reply surprising since all supporters of a reverse-charge system have so far advocated the need for accompanying reporting obligations. One Member State considers the reverse-charge system an efficient tool for limiting tax fraud possibilities (however not a general system but for particular areas).

The other Member States consider that the risk of migration of fraud can only be tackled if the Member States applying reverse-charge systems implement additional obligations and control efforts. The current available measures appear to be insufficient to address this risk.

The Member States also believe that the effectiveness and quality of the controls play an important role in where fraudsters decide to operate.

The additional measures indicated by some of the Member States as being necessary when implementing a generalised reverse-charge system are:

(a) Additional reporting obligations:

- Both seller and purchaser must submit transaction lists on reverse-charge transactions and these lists should be included in an electronic information system.

- Member States must share information on risky traders (one Member State).

- Suppliers operating under the reverse-charge procedure should obtain their customers' VAT registration number and satisfy themselves as far as possible that the number is genuine and the particular conditions are met (one Member State).

- Spontaneous exchange of information by Member States applying the reverse charge, e.g. information concerning observed phenomena, suspicious activities of taxpayers or indeed lists of entities (persons) which have ceased or significantly changed their activities following the implementation of this system (one Member State).

- Obligation to declare each reverse-charge transaction on line and to obtain prior authorisation for each transaction (one Member State).

(b) Additional control efforts:

- Suppliers must check the customer's ID (entrepreneurial status) and store documentation for these checks (three Member States).

- Tax administration has to develop a specific risk-management system to monitor the businesses applying the reverse charge (one Member State).

- Follow-up of the flow of goods by cross-checking each operation between supplier and customer at very short intervals, although it seems doubtful that tax administrations have the capacity to handle this quantity of data (two Member States).

- Implementation of stricter field controls of businesses applying the reverse-charge mechanism (one Member State).

- Cultivate audit officials' awareness of the fact that auditing along the distribution chain is necessary not only to safeguard VAT on final consumption in their own Member State but also in all other Member States (one Member State).

- Setting-up a database containing all suppliers applying the reverse charge and the use of targeted and fast information-exchange mechanisms (such as Eurocanet) to monitor reverse-charge transactions (one Member State).

Two Member States have real doubts about the efficiency of the possible additional reporting and control obligations. One Member State considers that each additional measure will increase the burden on businesses and tax administrations. Therefore, it could be a good idea to strengthen existing measures (quicker exchange of information and higher frequency of recapitulative statements).

3.3.3. Administrative cooperation as a tool against migration of fraud

The Member States were asked whether they found administrative cooperation measures effective in tackling the migration of fraud.

Three Member States stated they have no opinion or consider the question irrelevant, since they had not noticed any migration of fraud. Four Member States consider that they cannot evaluate the efficiency of the administrative cooperation because there is currently no (evidence of) migration of fraud caused by the implementation of a reverse-charge system in another Member State. Furthermore, they consider that the Member States that implemented the reverse-charge system must take the necessary measures to prevent migration of fraud.

Nevertheless, the majority of Member States replied to the question on the assumption that migration of fraud might occur. They acknowledge the essence and usefulness of administrative cooperation measures in tackling the migration of fraud, although they consider that this cooperation should be more intensive and could be improved through a number of actions for:

- quicker and flexible exchange of information (four Member States), and meeting of deadlines (two Member States);
- reduced timeframes for the VAT Information Exchange System (VIES), because currently the Member State of destination receives the information too late (three Member States);
- more detailed information on the tax forms (one Member State);
- spontaneous exchange of information concerning new frauds identified (fraudsters, new goods used for fraudulent activities) (one Member State);
- spontaneous exchange of information concerning new amendments to national regulations in accordance with the fight against specific fraud (one Member State);
- more use of the Trend Information Exchange Form (one Member State).

Four Member States mentioned explicitly the usefulness of the Eurocanet system as a tool in the fight against fraud, since suspicious cross-border transactions are continuously stored in this system.

3.3.4. *Effects on legitimate businesses*

No Member State thought that their businesses operating in a in a domestic market where the traditional VAT system operated would suffer as a result of having to compete with businesses operating in a reverse-charge market, where no VAT for business-to-business transactions was charged.

Member States did, however, see difficulties (and this is echoed by businesses) in situations where businesses were operating across the EU and would be required to adapt their systems in order to accommodate the reverse charge in a Member State. In that respect, businesses would be required to operate both the reverse-charge and the normal scheme in those Member States which have not adopted the reverse charge, and for business-to-consumer and transactions below the threshold in a Member State operating the reverse charge. This plethora of administrative systems may make their companies less competitive compared to those which deal with fewer administrative burdens and accounting systems. This is in addition to any extra reporting requirements which may be required in a Member State operating a reverse-charge measure.

3.3.5. *Conclusion*

So far experiences of migrated fraud are fairly non-existent other than a few specific cases in the scrap metal sector. However, the reverse charges most Member States apply today are targeted on particular commodities, and are often intended to combat frauds in which a small subcontractor works for a large business, collects the tax and fails to pay it. Often the commodities involved, such as waste, are of no interest for the general population and the reverse charge operates in a strictly defined, confined market.

This situation is different from the application of a wide reverse charge, where a large proportion of the goods supplied under the measure would be destined for the general retail market, with the tax being collected at that stage.

It is here that many Member States believed the greatest risk to their budgets and markets lay. They stressed the need for adequate control of the reverse charge, fearing that a plethora of untaxed goods would reach the markets of other Member States. This is because, at present, when goods are dispatched to another Member State, a right of refund is generated for the dispatching business. In order to receive this refund, certain obligations have to be fulfilled and the tax authorities in the Member State would carry out adequate checks to ensure the dispatch is genuine before making the repayment.

Under the reverse-charge system, however, this would not be the case as the business making the intra-Community dispatch would at most be in a small refund position due to purchases of low-value items or overheads below the threshold. Member States fear that, because the Member State of dispatch no longer faces a significant revenue risk, fewer resources would be targeted at policing intra-Community supplies. Indeed, some Member States believe that, as the greatest risk to domestic revenue would come from the retail end of the chain, the resources would simply not be available for policing dispatches to other Member States.

To counter such risks — more felt than clearly established — Member States suggest robust control measures. The Commission sees — as already explained — reporting requirements to be a key element, but administrative capacity also appears to be just as important, i.e. modern risk selection, audit capacities, monitoring tax-payers' registrations, etc. The Commission has the feeling that some of the contributions translate the fear of Member States that a Member State applying the general reverse charge would not be sufficiently motivated to effectively control its own businesses in situations where there is no risk to its own revenue, and thus would put at risk other Member States' revenues relating to cross-border trade. However, no evidence has been cited in that respect nor any example given from the past.

Moreover, Member States think that the existing administrative cooperation framework is not yet effective enough and does not allow a timely flow of relevant information: the effectiveness of the fight against the potential migration of MTIC fraud largely depends on a swift pro-active response necessitating targeted and quality information.

As to the impacts on businesses, the results clearly confirm the need to fully take into account additional costs generated by a change in system and not only in respect of established businesses but also — and perhaps even more so — regarding businesses situated in other Member States.

3.4. Coherence and harmonisation of VAT law in the EU

3.4.1. The aim of harmonisation

The fundamental principles outlined in the Treaty of Rome lie at the heart of the VAT system and have been consistently followed over the fifty years since the Treaty. These are that the VAT system should move towards harmonisation to the extent that this is necessary 'to ensure the establishment and the functioning of the internal market'. The Treaty was followed in 1967 by the First Directive on the harmonisation of legislation of Member States concerning turnover taxes (67/227/EEC), which aimed to reduce distortions of competition and promote the free movement of goods and services within the common market. The Directive abolished the various turnover-tax systems operating in Member States at that time (which were recognised as a hindrance to the efforts being taken to create a coherent union) and replaced them with a common system of Value Added Tax.

The First Directive only outlined in broad terms the working of the harmonised VAT system and was accompanied, at the same time, by the Second VAT Directive, which specified the principles regarding rates and the right of deduction. However, spurred on by the Council Decision of 21st April 1970 stating that, from 1975, the Community budget would be financed by own resources, of which VAT would be an innovative feature, the concept of a harmonised VAT system was further developed with the introduction of the 6th Directive (77/388/EEC) in 1977 (itself recast and simplified in Directive 2006/112/EC). This Directive brought together the rules for the common system of VAT, and acts as a model for many tax systems internationally. The Directive aimed to further align the system, and whilst it did not achieve complete harmonisation, allowing Member States some flexibility on various aspects such as rates, it was a significant step towards the commonality which had been the driving principle of the Community. Many of the flexibilities and derogations allowed to Member States are either explicitly limited in time or remain in place until the imposition of a definitive, harmonised system based on a system of taxation in the Member State of origin.

The progress towards more harmonisation and the effective removal of barriers to integrated trade was subsequently developed, with initiatives such as the elimination of internal borders in 1993 (which required closer cooperation between Member States), the SLIM (Simplification of Legislation in the Internal Market) initiative, the abandonment of the need for a fiscal representative for cross-border trade, and legislative changes such as the invoicing Directive in 2001. This progress is being further developed in current and future dossiers, such as the VAT package, simplification measures for small businesses, and VAT rates. **A wide reverse charge would expressly contradict the direction of developments in the VAT system, which has been driving towards easing trade in the EU and reducing the burdens on businesses**.

Thus, there is a clear imperative to design the tax in a way that it should be non-discriminatory as regards the origin of goods and services and neutral as to their stage of production or distribution, so that a common market permitting fair competition and resembling **a real internal market** may ultimately be achieved. Harmonised rules exist so as to set the conditions necessary for an internal market: best examples are the fundamental principles, such as the definition of a taxable person, the concept of taxable transactions and the place where supplies, acquisitions and imports are to be taxed. Article 395 of Directive 2006/112/EEC derogations are only allowed under specific conditions and in limited areas, but on the whole VAT is a transaction-based tax in which the revenue flows along the chain of transactions and VAT is collected and charged at each stage of the production, thus giving it a fractionated nature.

A generalised reverse-charge system would create a fundamental shift in the application of the VAT system, effectively eliminating its self-regulating, fractionated nature and putting the onus of collection onto the final stage of the transaction chain. This would have a number of repercussions affecting the general coherence and harmonisation of the VAT system. An optional reverse charge would threaten the fundamental drive towards harmonisation which has been the cornerstone of the VAT legislation in the fifty years since the Treaty of Rome, and would represent a significant step in the opposite direction. However, **of particular concern would be the operation of two distinct systems in the EU** which would come with an optional reverse charge, and the **threat to the coherence of the VAT system,** compromising its ability to accommodate current and future legislative changes which benefit the European Community as a whole.

3.4.2. The elimination of the fractionated system and practical application of the reverse charge

The fractionated procedure is one of the fundamental principles of the VAT system and provides it with a largely successful self-regulating mechanism, in that the output tax of one business is the input tax of another, providing both with an incentive to declare the tax correctly. In addition, it also means that, where a business fails to pay the VAT due to the administration, in most cases it is a fraction of the VAT which is lost, rather than the whole amount. It is true that both the fractionated system and the wide reverse charge rely on the sale to the final consumer (as VAT is a consumption tax) for the payment of the VAT in a transaction chain, but the way the tax is collected before this final consumption fundamentally differs between the two systems. In the fractionated system, the vast majority of businesses pay a fraction of the VAT to the Treasury regardless of where they are in the transaction chain. Under the reverse-charge system, the business which sells to the final consumer is mainly the only one in the transaction chain in a payment position. This fact concentrates the risk of non-payment of the VAT at the end of the transaction chain.

In fundamentally altering the nature of the VAT system by removing the fractionated system and shifting the responsibility of payment to the final stage, a general reverse charge would remove the incentive for businesses to account for the VAT properly. In that respect, and in order to ensure that transactions are nevertheless accounted for correctly, it would be necessary to impose additional reporting obligations on businesses[10]. Furthermore, under the reverse charge, the VAT treatment of a supply will crucially depend on the status of the customer. This again fundamentally differs

[10] These obligations may be more onerous on businesses than the current obligations on domestic sales, both to reassure the Member State that the reverse-charge system is not leading to domestic tax losses, and to assure those neighbouring Member States which are concerned about their losses as a result of the reverse charge.

from the current system, where — with the exception of certain goods and services — it is generally the properties of the goods or services supplied which dictate the VAT treatment of a transaction. In addition, a threshold would add a further complication to the measure. There would be, in effect, taxable persons who fall under the reverse-charge measure, taxable persons who do not fall under the reverse-charge measure because the supply is under the threshold, non-taxable persons, and in certain circumstances (where a supply is received for both taxable and non-taxable purposes) taxable persons who may fall under the reverse-charge measure for certain supplies, but not for others. All of these elements would need to be taken into account when the supplier is deciding whether or not to apply the reverse charge, and both businesses and Member States would need certainty as to these categories and when they apply.

These are only a few of the inevitable new rules that would need to be created and that will place in question some of the principles that have governed VAT harmonisation so far. For example, the content of reporting obligations — apart from minimum requirements — has been largely left to Member States as they have the responsibility to correctly and efficiently manage the VAT system. Where the viability of the reverse-charge system will, however, depend on the level of reporting requirements and verification possibilities — as those replace the self-policing set of payment and deduction — there will be a need to set such details at EU level. Again, this expressly contradicts the direction of developments of the VAT system, which has been driving towards easing trade in the EU and reducing the burdens on businesses.

The reverse charge would furthermore call for a number of specific rules across the tax system: an example may relate to the invoicing rules that would need to take into account such a new system. In addition, the impacts of specific schemes would have to be re-worked. For example, how would the reverse charge interact with the flat-rate scheme for farmers, or the margin schemes for second-hand goods or travel agents? An answer may be to exclude these schemes from the reverse charge, but again this would lead to an increasing level of disparity, another subset of businesses to which the wide reverse charge would not apply.

A wide reverse charge will lead to a shift in the way tax administrations administer and collect their tax, as they would concentrate their resources and efforts on where they see the most threat to their own revenue, that of the final stage. This may lead to less coherent auditing of the manufacture and wholesale stage, where VAT would no longer be collected and recorded. So, conversely, there would be a situation with the manufacture and wholesale stages being required to implement more stringent reporting and invoicing requirements, whilst at the same time the auditing and monitoring of these very businesses would decline.

Further to these considerations would be added some of the more practical aspects of applying the measures, such as the taxable person's responsibility to ascertain the correct liability. At present, it is the supplier who bears the responsibility of applying the correct VAT rate to the transaction. Under the wide reverse charge, this responsibility is shifted to the purchaser, who may not have such an accurate picture of the liability of his purchases (e.g. the correct application of VAT rates). In addition, there would be issues for a tax administration in distinguishing what is an exempt supply and what falls under the reverse charge, and the interaction of current

Article 395 derogations with that of the wide reverse charge. For example, a Member State may have a derogation for a reverse charge for a particular commodity, which is applied without a threshold. If a wide reverse charge with a threshold is introduced, how would this interact with existing reverse charges? It is entirely feasible that both were implemented for entirely different reasons, and so may not be practical to simply replace one with the other — a number of Member States apply a reverse charge to supplies of waste for example, and this is intended to combat fraud of a different nature to that which a wide reverse charge is intended to eliminate. In addition, Member States may need to re-evaluate their respective SME schemes, as, depending on the Member State, small businesses may play a greater role in the collection of the tax.

These modifications may nevertheless be considered to be of a rather technical nature, and if the political will is present for such a radical change to the VAT system it would be difficult to argue that **an EU-wide** VAT system based on a generalised reverse charge is as such incompatible with the objectives of harmonisation as stipulated by Article 93 of the Treaty.

On the other hand, the Commission cannot neglect its responsibility to maintain a tax in a format that also fulfils its revenue-raising function and it cannot be overlooked that VAT produces, in all Member States, some of the highest revenue levels of all taxes. A change in the system cannot be proposed as long as there is the remotest doubt as to the reliability of the new system and as to its fraud proofing.

3.4.3. Reverse charge as an obligation for Member States

So far, only certain Member States have shown an interest in using a wide reverse-charge mechanism to tackle fraud, and, accordingly, ECOFIN only considered its availability for Member States on an optional basis. This raises the fundamental question whether a voluntary system can still be considered to be compatible with the aim of harmonisation as explained above, and whether it threatens the coherence of the VAT system.

As pointed out in the previous sections, the differences between the system based on fractionated payments and a reverse-charge system are of a fundamental nature and would entail numerous changes to the overall rules of VAT. To say it clearly: **to allow for an optional reverse charge applicable in some Member States and not in others would mean the creation of a double VAT system.**

EU legislation is currently drafted and developed with a common framework in mind. A European Community with two VAT systems would necessitate consideration of both these systems when drafting and discussing legislation. It would be extremely difficult to add further developments to such a dual system in order to match the evolving internal market. **Such a biased system would put at major risk the future development of VAT in the European Union** as the interests of Member States in improving the VAT system would differ depending on the system they apply.

For example, the future development of work on subjects such as the One-Stop Scheme, on VAT obligations or to some extent on vouchers would all be significantly complicated by the implementation of an optional wide reverse charge.

Much more consideration would be required **at every level** on how these changes would interact — for instance, how is a traditional single-purpose face-value voucher to be treated if purchased in a Member State operating under the traditional VAT system yet redeemed by a business in a Member State operating the reverse charge? While this problem could be addressed by appropriate definitions, it still highlights what would be a recurrent issue when developing new legislation. Or under a maxi One-Stop Scheme, would different systems be required for those Member States operating the reverse charge?

Additionally, due to the elimination of the fractionated system, VAT obligations will be fundamentally different in Member States operating the wide reverse charge, and so these Member States would have entirely different priorities when discussing future amendments to these obligations. Indeed, under an optional wide reverse charge, the effects of **any proposed legislation** on both the traditional VAT system and the wide reverse charge would need to be considered when any such measures are discussed — a process and complication which would **seriously compromise the decision-making abilities of the EU on VAT matters and fundamentally threaten the coherence of the VAT system.**

This is in addition to the practical difficulties arising from having two separate systems. Primarily, certain sectors (such as construction) and pan-European businesses would be required to implement mirror accounting systems which operate both the traditional VAT system alongside a system to deal with those Member States which have implemented a wide reverse charge. This extra cost and dual system may also lead to a decline in the attractiveness of the EU as a marketplace for international trade.

Added to this would be an increase in the general level of business uncertainty within the EU. Should those Member States which have implemented a wide reverse charge be able to demonstrate to others that the system is a success, there may be increased pressure on the Governments of those Member States operating the traditional system to introduce the reverse charge themselves, leading to increased uncertainty amongst the business community.

3.4.4. Conclusion

A fundamental change to the VAT system on an optional basis would have **a significant detrimental effect on the coherence and harmonisation of the EU system as a whole**. Not least in that it would represent a step away from the coherence and harmonisation which benefits the European Union as a whole. It also opens up a number of difficulties in terms of its practical application, its apparent conflict with common EU objectives, and the application of future legislation.

The Commission accordingly has to take the view that it does not appear to be possible to have two VAT systems working contemporaneously. Either Member States should operate a classical VAT system or **all Member States should operate the reverse charge**. Any other solution would not respect the concept of a common VAT system and would not respect the wording and the spirit of Article 93 of the Treaty.

It is also recalled that the Commission and Member States are committed to reducing the burdens on businesses by 25% by 2012[11]. To that extent, the general direction of current and future legislative proposals seeks to reduce the burdens on business, or at the very least not to significantly increase these burdens. As the largely self-regulating nature of the VAT system will be eliminated under the reverse charge, more reporting requirements will be necessary in order to check its correct operation. This would be in direct conflict with the general reduction of burdens in Member States without the reverse charge. The European Community may then be in a situation in which it faces two-tier legislation, one which seeks to make trade easier for businesses and applies under the traditional system and the other which pulls in the opposite direction and applies to businesses operating in Member States implementing the reverse charge.

3.5. Conclusions on reverse charge

The Commission has to admit that it can neither be demonstrated that a reverse charge would be a perfect proportional solution to the problems caused by MTIC fraud nor can it be shown that reverse charge would not be an appropriate solution. This is due to the fact that such a radical and far-reaching change in the system has not yet been undertaken anywhere in the world and no concrete results are therefore available. It is for this reason that the Commission does not oppose the idea of running a pilot project which could be set up with strict criteria and conditions to take into account the results of the analysis to date and involve oversight by both the Commission and the Member States.

4. PILOT PROJECT

4.1. Introduction

The June 2007 ECOFIN Council expressed the wish to explore the potential effects of an optional reverse-charge mechanism by means of running a pilot scheme for a limited period of time in an interested Member State. This scheme would be open to any Member State.

Such a pilot project would legally have to be based on an **amendment to the VAT Directive**.

There are no results from the analysis carried out above that would indicate that the pilot should not take place. Nevertheless, the Commission would underline that in accordance with the preceding analysis, the pilot project would be undertaken with a view to establishing whether or not reverse charge as a concept can be proved to be successful and could be introduced on a **mandatory basis** at EU level so as to avoid a conflict with Article 93 of the Treaty and the compatibility of a harmonised VAT system with the wider objectives of the Treaty. **It could not be envisaged that a successful pilot project would result in allowing Member States to introduce reverse charge on an optional basis.**

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11 Action Programme for Reducing Administrative Burdens in the European Union (COM(2007) 23) as endorsed by the Spring Council of 2007.

4.2. Fundamentals

By definition a pilot project needs to be limited in time. On the other hand, it needs to run for a sufficiently long period to demonstrate its robustness and efficiency as well as its capacity to be fraud-proof. As its results could only be evaluated on the basis of statistical evidence that would only be available after a certain time lag, and given that there are major costs of change for businesses[12] and the tax administration concerned, a period of five years looks to be a minimum.

It would also be necessary to fix the evaluation criteria before the start of the project, and in particular to establish a methodology for measuring any reduction of tax fraud in general and MTIC fraud in particular. This would require a detailed *ex ante* assessment of the current situation in the volunteering Member State.

Moreover, the pilot would need to be continuously monitored as to its effects in order both to protect the Member State applying it against adverse consequences and to prevent negative effects for other Member States. It is suggested to create an *ad hoc* steering group that includes the Member State applying the system, its immediate neighbouring countries and the Commission.

Obviously, the Member State may suggest ending the pilot, but this should be formalised by a Council Decision after having heard the opinion of the steering group.

Details of the pilot scheme should be discussed with the Member States in the Commission's Working Party No 1. The debate should, in particular, focus on the following topics:

- Establishment of the evaluation criteria.
- Agreement on the methodology for establishing the results.
- Control measures which would be put in place in combination with the special reporting obligations to ensure correct application and to reduce, to the extent possible, new forms of fraud.
- How to organise feedback from industry affected by the measure.

4.3. Description of the system

Based *inter alia* on its contacts with the only Member State which has so far expressed an interest in acting as a pilot Member State, the Commission would see a potential system along the lines of the following principles:

- Application of a mandatory reverse-charge system, which makes the recipient liable for the payment of the VAT instead of the supplier, for domestic supplies of

[12] A recent Austrian study (commissioned by the Chamber of Commerce Vienna with the Austrian Institute for SME Research) estimated that the initial costs for small and medium-sized businesses to implement a pilot project would be in the order of €12 750 to €20 000 and the annual recurring cost would be between €6 050 and €9 000.

goods and services between taxable persons as from a taxable amount per invoice of €5 000 or more. Particular measures might be needed to avoid a single supply being split up over different invoices to remain under the threshold.

- The system would be based on verification of the validity of the VAT identification number of the purchaser. Additional measures for verifying the status of the purchaser as a taxable person might have to be imposed if the payment is settled by other means than via a bank account in the European Union.

- If this verification were correctly carried out by the supplier and the taxable status of the recipient were confirmed, solely the recipient would be liable for the payment of the VAT and for potential misuse of the VAT number (e.g. use for non-business purposes).

- In order to have a clear overview of the supplies under the reverse-charge system, special obligations will be necessary. This could take the form of a (monthly) listing by the supplier and the recipient.

- Special measures will have to be decided if the new generalised reverse-charge mechanism were to coincide with other existing situations of reverse charge.

4.4. Conditions which would have to be fulfilled by a volunteering Member State

The Commission would propose that the following should be the criteria for the acceptance of a Member State to carry out the pilot project:

(1) The volunteering Member State would have to be a "small" Member State with not more than one million taxable persons.

(2) The Member State should be able to demonstrate the size of the fraud problem that it is experiencing by means of a reliable methodology. It should also indicate the amount of additional VAT revenue which it expects to receive as a result of changing to reverse charge.

(3) An impact assessment would have to be done by the interested Member State to establish whether the costs to businesses of implementing the measure were proportionate to the VAT expected to be saved.

(4) The Member State should explain the measures taken to tackle fraud and why the classical control methodology has not worked to fight fraud.

(5) The length of the pilot project should be strictly limited. However, the Commission believes that a period of less than three years would not be sufficient time to allow the experiment to be bedded down and therefore adequately evaluated. On the basis that a proper evaluation would take in the order of six months, and then sufficient time should be given to businesses to allow them to change back to the classical system if it appears that reverse charge does not meet its objectives, the Commission proposes that the period for the pilot should be five years, with evaluation to commence at the end of the fourth year.

(6) The Member State volunteering as the pilot would not be able to revert back to the normal VAT arrangements before the end of the third year of the experiment.

(7) The volunteering Member State would supply the Commission with a detailed description of how it would propose to control businesses, including the additional human and financial resources which would be allocated to the control task. This information would not be published and would be classified as confidential.

(8) The Member State concerned would supply the Commission on a regular basis with the interim results of the experiment; particularly the evolution of VAT receipts and the size of the fraud problem. The Commission would keep the other Member States informed during information meetings under the auspices of Working Party No 1. During these meetings, the other Member States would report on any effects they had experienced. This could be regarding a possible spill-over effect of additional fraud arising from untaxed goods circulating on their markets as a result of the application of reverse charge in the volunteering Member State, or difficulties their taxable persons were experiencing in doing business in the Member State concerned, etc.

(9) The project evaluation would be carried out in the context of the work of Working Party No 1, and representatives of the businesses could be invited to give their experiences with operation of the system.

(10) The details of the obligations on taxable persons (listings, declarations, thresholds, obligations regarding the checking of the status of the customer) would be specified in the VAT Directive based on a proposal made by the Commission under Article 93 of the Treaty. The legislation would have a sunset clause.

(11) The volunteering Member State would be obliged to revert back to the classical VAT system at the end of the five-year test period.

5. ANNEXES

5.1. EU trade balances 2005 and 2006

	2005		2006	
Member State	Trade deficit €m	Trade surplus €m	Trade deficit €m	Trade surplus €m
AT	-10 092		-8 376	
BE		21 539		22 700
BG	-2 283		-2 384	
CY	-2 649		-3 042	
CZ		3 636		5 035
DE		98 946		103 087
DK		5 227		2 996
EE	-1 427		-2 852	
EL	-16 655		-18 363	
ES	-36 898		-37 406	
FI	-1 396			122
FR	-37 210		-38 664	
HU		3 537		4 105
IE		19 479		16 691
IT	-186		-738	
LT	-1 202		-2 481	
LU		749		1 410
LV	-2 087		-3 459	
MT	-1 226		-1 076	
NL		116 108		127 332
PL	-5 019		-3 608	

PT	-13 130		-13 432	
RO	-4 915		-7 647	
SI	-2 435		-2 247	
SK		197		1 216
SV	-1 609			222
UK	-55 212		-57 459	
Totals	-195 631	269 418	-203 234	284 916

5.2. Details on submission of VAT returns and recapitulative statements

Number of taxpayers submitting returns	27 959 318	
Taxpayers submitting recapitulative statements	1 213 313	4% of all taxpayers
Submitting monthly recapitulative statements	114 796	9% of all recapitulative statements
Submitting quarterly recapitulative statements	1 090 591	90% of all recapitulative statements
Submitting longer recapitulative statements	7 926	1% of all recapitulative statements
Taxpayers purchasing intra-Community	2 604 362	9% of all taxpayers